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FINANCE

The Warranty Windfall

Service contracts are cash cows -- but retailers are mum about their importance

Here's a secret two of the nation's largest consumer-electronics chains don't want investors to know. As TVs, portable DVD players, and other stuff fly off their shelves, Best Buy Co. (BBY) and Circuit City Inc. (CC) aren't banking on them to rake in the profits. Instead, they're counting on the extended warranty contracts that they sell aggressively along with the goods.

Warranties cost virtually nothing to market, and the products they insure rarely need repairs. Says FTN Midwest Securities Corp. analyst Daryl Boehringer: "It's just pure profit flowing down to the bottom line."

Last year, profits from warranties accounted for all of Circuit City's operating income and almost half of Best Buy's, say analysts. They figure that profit margins on contracts are between 50% and 60%. That's nearly 18 times the margin on the goods themselves. For example, a four-year contract on a $3,000 flat-panel TV costs about $400. Best Buy gives its insurers $160 and keeps $240 for itself.

But you won't find details of such fabulous returns in company financial statements. "We do not share information about specific profitability of any product or service sold at Best Buy," says Best Buy spokeswoman Sue Busch Nehring in an e-mail.

Accountants say the lack of detail raises questions about the transparency of earnings. And it's certainly information investors would want to know. Stiffer competition and an accelerating fall in the prices of big-ticket electronic items threatens those profits. "With their strong dependence on service-contract revenue, any pronounced slowdown would have a large negative impact on earnings," says Boehringer.

Indeed, Wal-Mart Stores Inc. (WMT) has jumped into consumer electronics in a big way and now controls 20% of the market. Best Buy, with $22 billion in sales in fiscal 2004, still has 31%. But Wal-Mart has passed Circuit City, which had $9.7 billion in sales last year and a 14% share.

Unlike the many specialist chains, Wal-Mart doesn't offer extended-service contracts; its lack of salespeople makes the contracts difficult to pitch. But if Wal-Mart, tempted by the eye-popping margins, decided to roll out its own line of warranties, it would have room to be even more cutthroat on electronics prices, and could conceivably undercut rivals on the warranty prices, too. Jim Sebastian, of SAFE LLC, a warranty consultancy, says he believes that Wal-Mart has tested contracts. Wal-Mart didn't return calls seeking comment.

GUESSING GAME

As service contracts become more critical to its bottom line, Best Buy has actually cut back on disclosure. The Richfield (Minn.)-based chain doesn't report its warranty profits separately, though it used to give the percentage of sales that the contracts comprised. It stopped doing that after fiscal 2001 and buried the number in a revenue category labeled "other." Then for fiscal 2004 it stopped reporting the "other" category altogether.

Circuit City is more forthcoming. The Richmond (Va.)-based outfit reports how much revenue the contracts generate, along with the percentage of sales they make up -- but not the profit they produce. For the year ended Feb. 29, it said its warranty revenue totaled $326 million, or 3.3% of sales. Clearly, says SAFE's Sebastian, the retailers "don't want to disclose to J.Q. Public how much money they are making on these contracts."

Using details gleaned from industry sources, though, analyst Boehringer put together estimates of just how lucrative these contracts are. For the year ended Feb. 28, he estimates contract profits accounted for 45%, or $600 million, of Best Buy's $1.3 billion operating profit. He figures that without contract profits, Circuit City would have posted an operating loss from continuing operations of $195 million last year instead of a $564,000 profit.

Neither Best Buy or Circuit City will discuss why they don't disclose more about their warranty business. Best Buy's Nehring says the products and the contracts should be seen as inseparable. Circuit City spokesman William Cimino says the retailer stands by its financial reporting and adds: "We feel we give an appropriate amount of information."

Critics say the companies are taking advantage of a gray area of accounting that involves judgment calls. Charles Mulford, a Georgia Institute of Technology accounting professor and expert on financial transparency, says the companies could make a case that product and contract sales are so intertwined that they don't need to be reported separately. But he contends that the companies should treat warranty sales as a separate business and break out its revenues and profits.

Under guidelines from the rulemaking Financial Accounting Standards Board, the contracts meet one important test for separate treatment: They provide more than 10% of operating profits. The contracts also meet another FASB test because company execs clearly treat warranty sales separately when they discuss how to boost that business, says Paul R. Brown, an accounting professor at New York University's Stern School of Business.

What's more, generally accepted accounting principles, or GAAP, call for the release of any facts that are material to a business and significant enough to influence investors. The trend at Best Buy toward providing less information, Mulford says, "flies in the face of this new world calling for more transparency in accounting."

EARLY ADOPTERS

Both Best Buy and Circuit City got serious about the warranty business in the mid-1990s. To jump-start contract sales, which then totaled less than 1% of revenue, Best Buy started pushing its employees to sell the contracts much harder. And it turned to insurance giant American International Group Inc. (AIG) to underwrite the plans so it wouldn't have to insure the products itself. Circuit City, meanwhile, turned to insurer AON Corp. (AOC) for much of its underwriting as it expanded its warranty sales.

For Best Buy, the strategic shift could not have been better timed. In the fourth quarter of fiscal 1996 -- when it disclosed that the contracts enjoyed higher margins than the products being insured -- Best Buy's operating profit fell 19%, owing to weak Christmas sales. Had it not enlisted AIG, its earnings would have been hit even harder. With AIG now carrying the risk of payments to repair or replace goods, Best Buy could book all the warranty revenue at the time of sale, instead of amortizing it over the life of the multiyear service contract.

At first, Best Buy was a little too aggressive in how it booked the new warranty revenue that streamed in. At the end of 1999, the Securities & Exchange Commission required Best Buy to restate earnings back through fiscal 1996, when it had turned to AIG. The problem? Even though Best Buy no longer carries the risk on the contracts, the chain is still held responsible for it under the laws of a handful of states where it has stores. So Best Buy had to readjust its results by amortizing contract revenue from those states, shaving a combined $49 million off operating profit for those four years, or 7%.

Now, there's reason for investors to be worried that the gusher of warranty revenues might slow. Contracts on expensive digital TVs with liquid-crystal displays, plus plasma TVs, account for well over half of such income at both retailers, analysts figure. But deflation on high-priced electronics is accelerating: Prices now fall by 45% every 18 months, nearly twice the rate of five years ago. As prices decline, consumers become less willing to buy the service plans, figuring that if their gadget breaks, they'll just buy a new one. The trend led to a fall last year in Circuit City's contract revenues to 3.3% of sales, from 3.6% the year before. So the company got employees to focus more intensely on selling contracts, a campaign that paid off in the latest quarter, when the figure kicked up to 4.1%.

Deflation isn't the only negative for investors. The retailers are in a sweet spot now as consumers switch from analog to digital TVs, but that transition will wind down in the next couple of years, analysts say. Soon investors may be wishing they could buy an extended warranty on profits at the electronics chains.

By Robert Berner in Chicago

Auto Service Contracts

Buying a car? You also may be encouraged to buy an auto service contract to help protect against unexpected, costly repairs. While it may sound like a good idea, don't buy in until you understand both the terms of the contract and who is responsible for providing the coverage.

The Auto Service Contract

A service contract is a promise to perform (or pay for) certain repairs or services. Sometimes called an "extended warranty," a service contract is not a warranty as defined by federal law. A service contract may be arranged at any time and always costs extra; a warranty comes with a new car and is included in the original price.

The separate and additional cost distinguishes a service contract from a warranty.

The Terms

Before deciding whether to buy an auto service contract, ask these questions:

Does the service contract duplicate any warranty coverage?

Compare service contracts with the manufacturer's warranty before you buy. New cars come with a manufacturer's warranty, which usually offers coverage for at least one year or 12,000 miles, whichever comes first. Even used cars may come with some type of coverage (see page 3).

You may decide to buy a "demonstrator" model—a car that has never been sold to a retail customer but has been driven for purposes other than test drives. If so, ask when warranty coverage begins and ends. Does it date from when you purchase the car or when the dealer first put the car into service?

Who backs the service contract?

Ask who performs or pays for repairs under the terms of the service contract. It may be the manufacturer, the dealer, or an independent company.

Many service contracts sold by dealers are handled by independent companies called administrators. Administrators act as claims adjusters, authorizing the payment of claims to any dealers under the contract. If you have a dispute over whether a claim should be paid, deal with the administrator.

If the administrator goes out of business, the dealership still may be obligated to perform under the contract. The reverse also may be true. If the dealer goes out of business, the administrator may be required to fulfill the terms of the contract. Whether you have recourse depends on your contract's terms and/or your state's laws.

Learn about the reputation of the dealer and the administrator. Ask for references and check them out. You also can contact your local or state consumer protection office, state Department of Motor Vehicles, local Better Business Bureau, or local automobile dealers association to find out if they have public information on the firms. Look for the phone numbers and addresses in your telephone directory.

Find out how long the dealer or administrator has been in business, and try to determine whether they have the financial resources to meet their contractual obligations. Individual car dealers or dealer associations may set aside funds or buy insurance to cover future claims. Some independent companies are insured against a sudden rush of claims.

Find out if the auto service contract is underwritten by an insurance company. In some states, this is required. If the contract is backed by an insurance company, contact your State Insurance Commission to ask about the solvency of the company and whether any complaints have been filed.

How much does the auto service contract cost?

Usually, the price of the service contract is based on the car make, model, condition (new or used), coverage, and length of contract. The upfront cost can range from several hundred dollars to more than $1,000.

In addition to the initial charge, you may need to pay a deductible each time your car is serviced or repaired. Under some service contracts, you pay one charge per visit for repairs—no matter how many. Other contracts require a deductible for each unrelated repair.

You also may need to pay transfer or cancellation fees if you sell your car or end the contract. Often, contracts limit the amount paid for towing or related rental car expenses.

What is covered and not covered?

Few auto service contracts cover all repairs. Indeed, common repairs for parts like brakes and clutches generally are not included in service contracts. If an item isn't listed, assume it's not covered.

Watch out for absolute exclusions that deny coverage for any reason. For example:

- If a covered part is damaged by a non-covered component, the claim may be denied.
- If the contract specifies that only "mechanical breakdowns" will be covered, problems caused by "normal wear and tear" may be excluded.

If the engine must be taken apart to diagnose a problem and it is discovered that non-covered parts need to be repaired or replaced, you may have to pay for the labor involved in the tear-down and re-assembling of the engine.

You may not have full protection even for parts that are covered in the contract. Some companies use a "depreciation factor" in calculating coverage: the company may pay only partial repair or replacement costs if they consider your car's mileage.

How are claims handled?

When your car needs to be repaired or serviced, you may be able to choose among several service dealers or authorized repair centers. Or, you may be required to return the vehicle to the selling dealer for service. That could be inconvenient if you bought the car from a dealership in another town.

Find out if your car will be covered if it breaks down while you're using it on a trip or if you take it when you move out of town. Some auto service contract companies and dealers offer service only in specific geographical areas.

Find out if you need prior authorization from the contract provider for any repair work or towing services. Be sure to ask:

- how long it takes to get authorization.
- whether you can get authorization outside of normal business hours.
- whether the company has a toll-free number for authorization. Test the toll-free number before you buy the contract to see if you can get through easily.

You may have to pay for covered repairs and then wait for the service company to reimburse you. If the auto service contract doesn't specify how long reimbursement usually takes, ask. Find out who settles claims in case you have a dispute with the service contract provider and need to use a dispute resolution program.

Are new or reconditioned ("like") parts authorized for use in covered repairs?

If this concerns you, ask. Some consumers are disappointed when they find out "reconditioned" engines are being used as replacement parts under some service contracts. Also ask whether the authorized repair facility maintains an adequate stock of parts. Repair delays may occur if authorized parts are not readily available and must be ordered.

Used Cars: Warranty Protection

When shopping for a used car, look for a Buyer's Guide sticker posted on the car's side window. This sticker is required by the FTC on all used cars sold by dealers. It tells whether a service contract is available. It also indicates whether the vehicle is being sold with a warranty, with implied warranties only, or "as is."

- Warranty. If the manufacturer's warranty is still in effect on the used car, you may have to pay a fee to obtain coverage, making it a service contract. However, if the dealer absorbs the cost of the manufacturer's fee, the coverage is considered a warranty.
- Implied Warranties Only. There are two common types of implied warranties. Both are unspoken and unwritten and based on the principle that the seller stands behind the product. Under a "warranty of merchantability," the seller promises the product will do what it is supposed to do. For example, a toaster will toast, a car will run. If the car doesn't run, implied-warranties law says that the dealer must fix it (unless it was sold "as is") so that the buyer gets a working car. A "warranty of fitness for a particular purpose" applies when you buy a vehicle on a dealer's advice that it is suitable for a certain use, like hauling a trailer. Used cars usually are covered by implied warranties under state law.
- As Is - No Warranty. If you buy a car "as is," you must pay for all repairs, even if the car breaks down on the way home from the dealership. However, if you buy a dealer-service contract within 90 days of buying the used car, state law "implied warranties" may give you additional rights.

Some states prohibit "as is" sales on most or all used cars. Other states require the use of specific words to disclaim implied warranties. In addition, some states have used car "lemon laws" under which a consumer can receive a refund or replacement if the vehicle is seriously defective. To find out about your state laws, check with your local or state consumer protection office or attorney general.

What are your responsibilities?

Under the contract, you may have to follow all the manufacturer's recommendations for routine maintenance, such as oil and spark plug changes. Failure to do so could void the contract. To prove you have maintained the car properly, keep detailed records, including receipts.

Find out if the contract prohibits you from taking the car to an independent station for routine maintenance or performing the work yourself. The contract may specify that the selling dealer is the only authorized facility for servicing the car.

What is the length of the service contract?

If the service contract lasts longer than you expect to own the car, find out if it can be transferred when you sell the car, whether there's a fee, or if a shorter contract is available.

Other Tips

If you're told you must purchase an auto service contract to qualify for financing, contact the lender yourself to find out if this is true. Some consumers have had trouble canceling their service contract after discovering the lender didn't require one.

If you decide to buy a service contract through a car dealership—and the contract is backed by an administrator and/or a third party—make sure the dealer forwards your payment and gives you written confirmation. Some consumers have discovered too late that the dealer failed to forward their payment, leaving them with no coverage months after they signed a contract. Contact your local or state consumer protection office if you have reason to believe that your contract wasn't put into effect as agreed.

In some states, service contract providers are subject to insurance regulations. Find out if this is true in your state. Insurance regulations generally require companies to:

- maintain an adequate financial reserve to pay claims.
- base their contract fees on expected claims. Some service providers have been known to make huge profits because the cost of their contracts far exceeds the cost of repairs or services they provide.
- seek approval from the state insurance office for premiums or contract fees.

Complaints

To report contract problems with a service provider, contact your local and state consumer protection agencies, including the state insurance commissioner and state attorney general.

If you need help resolving a dispute, contact the Better Business Bureau, the state attorney general, or the consumer protection office in your area. Also, contact law schools in your area and ask if they have dispute resolution programs.

You also can contact the FTC. The FTC works for the consumer to prevent fraudulent, deceptive, and unfair business practices in the marketplace and to provide information to help consumers spot, stop, and avoid them. To file a complaint or to get free information on consumer issues, call toll-free, 1-877-FTC-HELP, or use the complaint form at www.ftc.gov. The FTC enters Internet, telemarketing, identity theft, and other fraud-related complaints into Consumer Sentinel, a secure, online database available to hundreds of civil and criminal law enforcement agencies in the U.S. and abroad.